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Understanding the Right of Reimbursement for Defense Costs When Reserving Rights

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When an insurance company defends its insured under a reservation of rights, the question arises as to whether the insurer has a right to seek reimbursement from its insured for payments made toward attorney's fees and court costs when it is determined that no coverage exists and, therefore, the obligation to defend may not have arisen under the policy. There is no clear majority among the courts that have ruled on the issue of whether an insurer is entitled to the reimbursement of fees and costs expended in the defense.

Five states favor reimbursement to the insurance company: California, Colorado, Connecticut, Florida and New Jersey.

An equal number of states have disallowed reimbursement: Illinois, Pennsylvania, Montana, Texas and Wyoming.

At the federal level, the courts are split. Eight federal courts have permitted reimbursement: Alaska, Arkansas, Hawaii, Kentucky, Michigan, New York, Ohio, and Virginia, while six states have disallowed reimbursement: Georgia, Maryland, Massachusetts, Missouri, Nevada, and New Mexico.

At least one federal district is split within itself.

The federal court in Minnesota has both permitted and disallowed reimbursement. As an example, in *Knapp v. Commonwealth Land Title Ins. Co., Inc., 932 F.Supp. 1169, 1171-72 (D. Minn. 1996)*, the Court found that reimbursement was permissible where the insurance company had sufficiently reserved its right of recoupment while the Court's decision in *Employers Mut. Cas. Co. v. Industrial Rubber Products, Inc., 2006 WL 453207 (D. Minn. 2/23/06)*, found that the entitlement to reimbursement must exist as an express provision of the insurance policy in order to permit reimbursement.

Against this backdrop of division, insurance companies should reserve their rights to seek reimbursement for payment of noncovered causes of action within their reservation of rights letter. See, e.g., *Capital Indem. Corp. v. Blazer, 51 F.Supp.2d 1080, 1090-91 fn.6 (D. Nev. 1999).*

Some courts have found that the insurance company is entitled to recoup its defense costs if it gives a timely notice to its insured that it is reserving its rights to seek reimbursement. See, e.g., *United National Ins. Co. v. SST Fitness Corp., 309 F.3d 914 (6th Cir. 2002)*. The Court in United National allowed the insurance company to recover under an implied in fact contract theory provided that the insurer timely and explicitly reserved its right to recoup the costs and provided specific and adequate notice of the possibility of reimbursement. The Court found that this approach promoted the policy of ensuring that defenses were afforded to the insured even in questionable cases.

The Court made the following relevant observation:

When an insurer conditions payment of defense costs on the condition of reimbursement if the insurer had no duty to defend, the condition becomes part of an implied in fact contract when the insured accepts payment. When faced with a reservation of rights, the insured can choose to: 1) decline the offer, pay for the defense, and seek to recover on the policy; 2) decline the offer and file a declaratory judgment action; or 3) accept the offer subject to the reservation of rights.

The purpose of the reservation of rights is to eliminate the volunteer and waiver defenses to the reimbursement action, as well as to satisfy the notice requirement to a restitution claim.

Other courts have rejected the implied in fact contract which may be created when the insured accepts defense after a properly communicated reservation of rights seeks reimbursement of defense costs. These courts have found that an insurance company's unilateral assertion of a right to reimbursement does not give rise to any obligation on the part of the insured, absent some express agreement on the part of the insured to do so or a specific policy provision compelling reimbursement. See, e.g., *Medical Malpractice Joint Underwriting Ass'n v. Goldberg, 680 N.E.2d 1121 (Mass. 1997)*.

Where the insured objects to that part of the reservation of rights letter which reserves the right to seek reimbursement, the insured's objection may defeat the right of reimbursement. See, *Resure, Inc. v. Chemical Distributors, Inc., 927 F.Supp. 190 (M.D. La. 1996) (applying New Mexico law)*.

One of the most cited cases for implied reimbursement is the California Supreme Court's decision in *Blue Ridge Ins. Co. v. Jacobson, 22 P.3d 313 (Cal. 2001)*. In Blue Ridge, the California Supreme Court adopted the implied reimbursement rule. Under this rule, an insurance company has a right of reimbursement for defense costs that can be allocated solely to claims not potentially covered which is implied in law as quasi-contractual, irrespective of whether the insurer has an implied in fact right of reimbursement in the policy.

The Court supported the result by reasoning that insurers do not bargain to bear these types of costs where no coverage exists and the insured has not paid the premiums for that risk. The Court looked to the law of restitution to support its conclusion. Under the law of restitution, such a right runs against the person who benefits from "unjust enrichment" and in favor of the person who suffers loss thereby.

The "enrichment" of the insured by the insurance company through the insurer's bearing of unbargained-for defense costs is inconsistent with the insurer's freedom under the policy and therefore must be deemed "unjust." To receive the right of reimbursement, the insurance company is required to reserve its right to seek reimbursement.

An interesting turn in the road can occur in reimbursement situations where the insurer reserves its rights to seek reimbursement which is then rejected by the insured. The insured can accept the reservation of rights

defense but object in a limited fashion to the insurer's right of reimbursement. At that point, the insurance company may run the risk of waiving its right to seek reimbursement by proceeding forward with the reservation of rights defense.

This is similar to the situation described above where it is the insured who does not object and proceeds forward with accepting the reservation of rights defense with the consequence being an implied in fact acceptance of the right of reimbursement.

The risks are much more substantial to the insurance company, however. If the insurance company refuses to proceed with the defense, it then risks serious consequences including bad faith exposure. In that situation, it is recommended that the insurance company work with the insured to reach a collateral understanding that the company's provision of the reserved defense does not constitute a formal waiver, if a right exists, to seek reimbursement.

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